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FM AMEMBASSY JAKARTA
TO RUEHC/SECSTATE WASHDC 6027
RUEATRS/DEPT OF TREASURY WASHINGTON DC
INFO RUEHXS/ASSOCIATION OF SOUTHEAST ASIAN NATIONS
RUEHKO/AMEMBASSY TOKYO 9865
RUEHBJ/AMEMBASSY BEIJING 3489
RUEHBY/AMEMBASSY CANBERRA 9632
RUEHUL/AMEMBASSY SEOUL 3678
RUEHBR/AMEMBASSY BRASILIA 0177
RUEHBU/AMEMBASSY BUENOS AIRES 0030
RUEAIIA/CIA WASHDC

UNCLAS SECTION 01 OF 03 JAKARTA 007718

SIPDIS

SENSITIVE
SIPDIS

DEPT FOR EAP/MTS AND EB/IFD/OMA
TREASURY FOR IA-BAUKOL
DEPARTMENT PASS FEDERAL RESERVE SAN FRANCISCO

E.O. 12598: N/A

TAGS: [EFIN](#) [EINV](#) [ECON](#) [PGOV](#) [PREL](#) [ID](#)

SUBJECT: BANK INDONESIA TO CONTINUE CAUTIOUS LOWERING

REF: A) JAKARTA 7013, Early IMF Repayment;
B) JAKARTA 7340 Economic Highlights May

11. (SBU) Summary. Bank Indonesia (BI) Deputy Governor Hartadi Sarwono told us on June 13 that BI remains confident consumer price inflation will fall to less than seven percent on a year-on-year (YoY) basis by the end of 2006, leaving BI room to continue a "cautious lowering" of interest rates over the next six months. He said BI has run a series of foreign reserve simulations, and is comfortable with its current reserve level of about USD 44 billion, although the risk of renewed, rapid portfolio outflows remains a concern. Despite the expected downward trend in interest rates, Sarwono expressed concern about the prospects for GDP growth in 2006--the Ministry of Finance, BI, the International Monetary Fund (IMF) and others have revised 2006 GDP growth estimates for Indonesia downward to below 6 percent due to lower government spending and investment. Like in other emerging economies, capital markets have been volatile in Indonesia in recent weeks, but Sarwono and the majority of our economic contacts believe the country is in a solid macroeconomic position to weather the current storm. End Summary.

12. (SBU) We met BI Deputy Governor Dr. Hartadi Sarwono on June 13 to explore BI's thinking about the likely course of Indonesia's monetary policy over the remainder of 2006. Sarwono is a former Director for Economic Research and Monetary Policy at BI and perhaps the top macroeconomist on the BI board. Our contacts consistently place him among the interest rates "hawks" on the BI board along with Senior Deputy Governor Miranda Goeltom and Deputy Governor Bun Bunan E. J. Hutapea. In contrast, BI watchers cite Deputy Governors Maman H. Somantri and Aslim Tajuddin as the leading proponents of a more accommodating monetary policy, with frequent support from BI Governor Burhanuddin Abdullah. BI sets monetary policy at monthly meetings of its Board of Governors.

Interest Rate Lowering will Continue

13. (SBU) Sarwono made it clear that that BI believes inflationary pressures are falling, and predicted that YoY consumer price inflation would fall below eight percent by October 2006 and to less than seven percent by year-end. He

said BI wants to keep real interest rates at about three percent, which would give the bank scope to reduce its benchmark BI rate to 11 percent by year's end. With rates currently at 12.5 percent, Sarwono said he believes the most likely interest rate scenario would be continued, cautious lowering through the end of 2006, 25 basis points at a time. However, Sarwono admitted this scenario depends on the course of the U.S. federal funds rate. BI seeks to keep the difference between the U.S. federal funds rate and the BI rate at about six percent, so if the federal funds rates rises much beyond current levels, it will leave less maneuvering room for BI.

¶4. (SBU) While noting that BI does not directly target the Rp/USD exchange rate, Sarwono said Indonesia enjoys a comfortable stock of foreign exchange reserves (USD 44.2 billion as of May 31) that should permit it to accommodate continued capital outflows without undue pressure on the rupiah. BI has performed a series of simulations of reserve scenarios, including one that sets short-term capital outflows at twice the total year-to-date inflows. As a result of the scenarios, Sarwono said BI is confident Indonesia has sufficient reserves to cover 4-5 months of imports and short term debt repayments. Nonetheless, he acknowledged BI is concerned about renewed, rapid outflows of portfolio capital if rates drop too quickly. He said the stock of foreign-held BI certificates (SBIs) had dropped sharply after the mid-May emerging market sell-off from Rp 22 trillion (USD 2.4 billion) to Rp 10 trillion (USD 1.1 billion). However, the broader government bond market and stock market had fared much better during the recent emerging market sell-off, Sarwono claimed, with a small, net outflow from the former and two-way movement and profit

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sharing in the latter.

Concerns About Currency Volatility

¶5. (SBU) Sarwono confirmed that concerns about the possible impact of a second, 25-basis point cut in rates on the Rp/USD exchange rate led BI's Board of Governors to leave rates unchanged at its June 6 meeting. He claimed part of the rupiah's volatility can be traced to the character of Indonesia's foreign exchange markets, which are very thin (daily turnover of USD 300 - 350 million) and operate almost exclusively on a spot basis. The thin spot market leads to wide swings during the trading day, Sarwono said, which are reported on Bloomberg and affect market psychology. Sarwono said BI is working hard to develop swap and forward markets to take some of the pressure off the spot market. (Note: Some investors use a Singapore-based "non-deliverables market" to manage volatility via swaps and options.) A contact at the IMF office in Jakarta noted that intra-day currency trading of the rupiah sometimes swings as much as 600 points against the dollar in a single day, making it hard for businesses to plan.

¶6. (SBU) Investment bankers we spoke with confirm that most of the money that wanted to leave Indonesia has already left. "Yields are still attractive here...some who left are waiting to come back in and buy bonds, expecting the interest rate to drop," one noted. Another said, "Indonesia is politically stable, has a balanced budget, a low deficit, a trade surplus and a current account surplus. This is attractive to many investors."

Concerns Mounting about Slow Growth

¶7. (SBU) BI's cautious plan for lowering short-term rates has left Sarwono and other economists concerned about the prospects of GDP growth in 2006. The Minister of Finance announced on June 14 a growth estimate of 5.9 percent for 2006, revised downward from the budget assumption of 6.2

percent. For its part, the IMF revised downward its GDP growth estimate for 2006 to 5.2 percent. Sarwono is concerned that both central and regional government spending remains much lower than expected (Ref B) and that infrastructure investment and spending probably will not get seriously underway until 2007. Regional governments (provinces and districts) account for approximately one third percent of total government spending, and there is clear evidence of spending backlogs at the local level. "The regions are sitting on Rp 28 trillion (USD 3 billion) of SBIs," Sarwono told us, "which they should disburse via social spending." However, Coordinating Minister for the Economy Boediono told donors on June 14 that he is confident government spending would pick up in the second half of 2006. The World Bank was also a bit more optimistic, noting that the GOI traditionally backloads public spending, now 6.9 percent of GDP, which could rise to 20 percent by the end of the year.

Capital Markets Volatile

18. (SBU) Indonesia's foreign exchange, stock, and government bond markets have remained volatile over the past week. However, our contacts in the financial markets believe the volatility is part of a global trend rather than an Indonesia-specific one. "Money is moving around the world very quickly," one trader told us. "The amount of money investing globally has grown dramatically in the last 18 months, but investors view Indonesia as more politically and macro-economically stable than other emerging markets, so will sell Indonesia last." Another investment banker agreed, "there is a mountain of liquidity in every country looking for high returns, and Indonesia offers attractive rates."

Comment

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19. (SBU) Indonesia seems well positioned to weather the current wave of emerging markets volatility. It has a small budget deficit, declining inflation, a comfortable reserve level, and a very highly regarded team of economic ministers. Our contacts also express optimism about BI's ability to manage the delicate move to lower interest rates in a climate of emerging market volatility and declining risk appetites among many investors. A more difficult challenge will be finding ways to boost growth given the very slow progress on government spending and investment climate reforms. BI Governor Abdullah has already speculated to the press about accelerating the move to lower interest rates, and we expect continued pressure on BI to find a way contribute to higher growth levels.

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